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AUGUST 21 1991

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WHY MIDSCALE RESTAURANTS FIT THE '90s MARKET

FOOD FEATURES

SOUTHWESTERN MENU IDEAS

BRAISING BEEF

MATCHING PASTA & SAUCES

Wrap Session: Beef Fajitas & Tortillas

BIG CHAINS FLOCK TO FRANCHISING

Operators Winners In Credit Card Wars

MORE INSIDE! SEE PAGE 4

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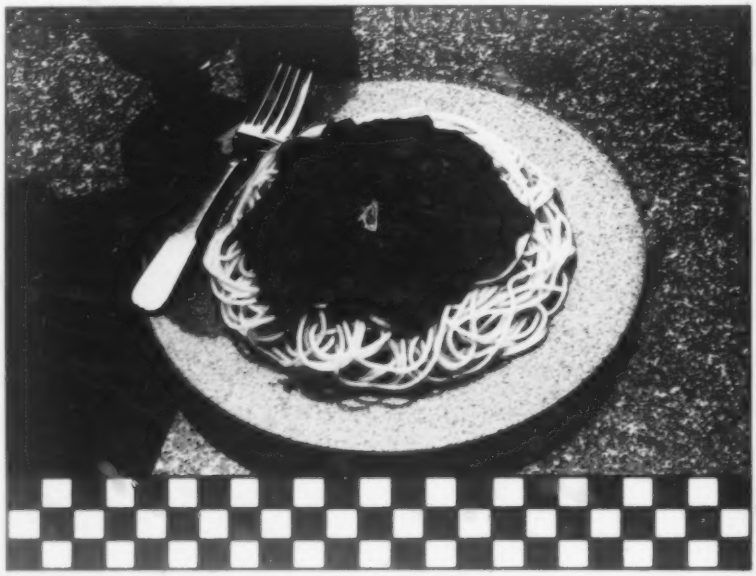

26 R&I EXCLUSIVE: MIDSCALE ADVANTAGE

The downturn in consumer spending and changing demographics have created a trade-down in the public's choices of dining experiences. Even upscale customers are turning to casual, midscale restaurants where they find familiar foods with comfortable prices served in friendly surroundings. The Silver Diner, The Olive Garden and The Ground Round talk about their competitive marketing moves.

56 ABOUT THE COVER: SOUTHWEST COOKERY GOES MAINSTREAM

Southwestern ways with food have migrated from Arizona, New Mexico and Texas to operations everywhere. The appeal? Operators like the low food cost and easy preparation of foods that result in dishes with lots of flavor and style. Our Taste feature delivers an update on Southwest menu trends such as fajitas (on the cover), quesadillas and guacamole. Recipe ideas include Chicken Tamale with Green Anaheim Chili and Raisins from Vincent's on Camelback, Scottsdale, Ariz.

97 THE CREDIT-CARD COMPETITION FOR CUSTOMERS

In the battle among American Express, Visa and Discover, customers and operators will come out on top, no matter which company wins the market-share fight. While American Express is rolling out an extensive restaurant support program, Visa is stepping up its advertising with local restaurant promotions. And Discover is quietly playing its trump cards: lower user fees and a cash-back program. Will fees drop further? Hear what credit-card industry analysts have to say, as well as restaurateurs who are taking sides.

112 BRAISING BEEF FOR CLASSIC ENTREES

Today's pricey fillet and porterhouse steak are sharing prime time with soul-satisfying, one-pot braised beef dishes. Less costly cuts of beef, marinated and slow-simmered with vegetables and herbs, are enjoying repeat performances on menus. We also explore stews and braises from other countries, for instance Hungarian Gulyas and Mexican-style Caldo de Carne.

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R&I REPORT

TRENDS

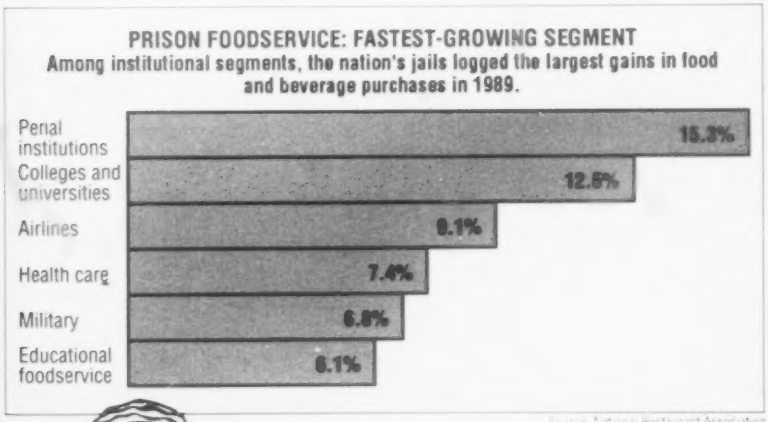
BURSTING PRISONS STRAIN FEEDING PROGRAMS

Huge increases in prison populations are straining foodservice operations. And the problems have only deepened during the recession.

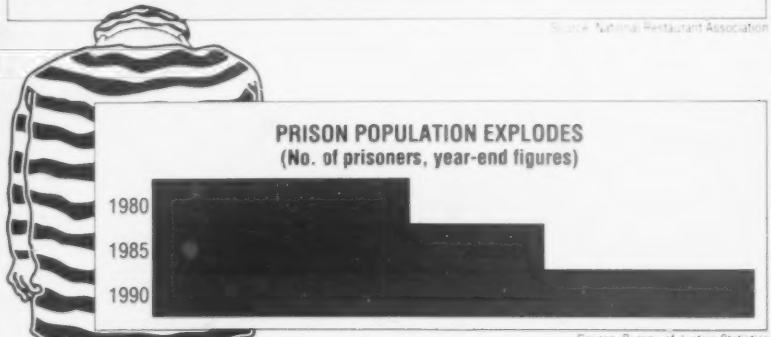
Over the past decade, the number of inmates in U.S. lockups has jumped 134% to more than 770,000, while food and beverage purchases have vaulted 200%, to nearly $1.4 billion.

State and local budget woes are placing prison feeding programs under pressure. At the same time, surplus commodities, which the government once gave to prisons for the cost of shipping, have all but dried up. Prisons now are forced to buy staple items they used to receive for pennies on the dollar—including grains, dairy products and peanut butter—at market prices.

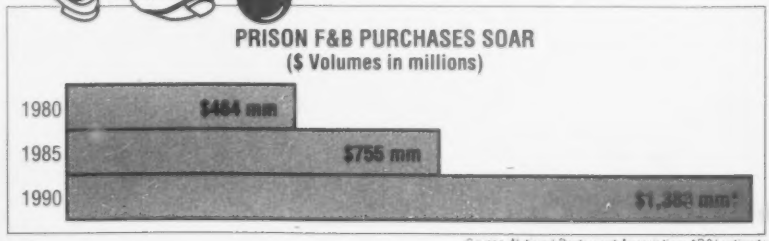
—Rajan Chaudhry



Source: National Restaurant Association



Source: Bureau of Justice Statistics



Source: National Restaurant Association; *R&I estimate

Menus: Fresh tortillas and hickory-grilled foods will set apart Bob Evans' Cantina del Rio concept.

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service and value keep the midscale segment on steady footing? Some say it starts with the menu.

MAXIMIZING MENUS

Wide menus are essential for a midscale restaurant's success. Familiar menu fare such as simple sandwiches, hamburgers, meatloaf and pot pies appeal to most customers and provide something for every member of a family or party.

At Perkins Family Restaurants, Memphis, Tenn., recent menu additions don't stray too far into exotic territory, according to Donna Guido, spokeswoman. Newer items include a bread-bowl salad, in which a scooped-out loaf of bread serves as a salad bowl; pot pies that actually are layered puff pastry with filling inside; and shepherd's pie, a savory pie filled with ground beef, corn and onions and topped with a mashed-potato crust.

The two Silver Diners serve mainstream food—turkey with stuffing and meatloaf with mashed potatoes—but use innovative preparation methods, Giaimo says. The cooks use less salt and make up for it with more herbs. The turkey served at the diners is roasted with rosemary. The vegetables in the standard fried-vegetable basket are coated in specially seasoned bread crumbs, says Giaimo.

Because large chains often don't enjoy the same customer perception of menu flexibility as independent operators, The Ground Round, South Weymouth, Mass., has created a line of "Made From Scratch" menu specials—chefs at each unit choose from a core of corporate recipes for such familiar foods as London broil, meatloaf and turkey with dressing and announce each day's selections on a blackboard, says Judy Kelly, vice president of marketing. Customers get the impression that the chef exercises creativity rather than just sticking to recipes on the regular menu.

At The Olive Garden, Orlando, Fla., the corporate focus is on maintaining a chain of independent restaurants, says Anne Powell, spokeswoman for parent company General Mills. "We tailor our menus to the local market. For instance, in Milwaukee, we offer a Friday-night fish fry. It's the second-most popular entree, yet we don't do

continued on page 36

Cantina del Rio will target two hot demographic groups—young professionals and two-wage-earner households.

UPSCALE AIMS FOR MIDDLE GROUND

In a National Restaurant Association Survey released earlier this year, operators told of lowering prices and adding easy-to-make and cost-efficient items to their menus to attract more customers and generate more profits.

Action taken	$8-$14.99	$15-$24.99
Cut menu prices	15%	35%
Added lower-priced items	48	59
Added grilled dishes	51	84
Added pasta dishes	59	76
Added light entrees	61	76

National Restaurant Association Tableservice Operator Survey

CONFIDENCE INDEX SHOWS FULL-SERVICE TRAFFIC UP

The latest *R&I* Business Confidence Index, released in June, paints a pleasant picture for full-service restaurants. While the index does not break full-service out into upscale and midscale, it does point out that customers are coming out in increasing numbers to dining establishments where they can sit, relax and be waited on during their meals.

Traffic counts	Full service	Fast food
Up more than 10%	50%	20%
Up 1% to 10%	15	30
No change	20	40
Down 1% to 10%	10	10
Down more than 10%	5	0

R&I Business Confidence Index, June 1991

■ EXPANSION STRATEGIES

CHAINS FLOCK TO FRANCHISING

High investment and high risk are leading many major players to cut back on company stores, but at what cost?

By Rajan Chaudhry

Faced with the climbing costs and risk of building restaurants, many of the nation's top chains are moving from selling soft drinks and sandwiches to customers to selling stores and services to franchisees.

□ Since 1988, McDonald's has closed or sold to franchisees 14% of its U.S. company-owned stores. In the process, the chain has cut company stores to 17% from 22% of its domestic system.

□ Since 1986, Wendy's has disposed of 20% of its company stores, paring its company-owned stores to 40% from 55% of its U.S. system.

□ Last year, Carl's Jr. announced plans to cut company stores to 60% of its system from about 80% within five years. It unveiled a strategy to franchise 57 company stores in Northern California that called for franchisees to open 60 new units within five to 10 years. Carl's has since taken a $14.5 million charge for the disposition or franchising of 40 Arizona stores.

□ And in June, Shoney's Inc. announced the sale of its motel division to concentrate on a national restaurant-franchising campaign for Shoney's and Captain D's. The quickened pace of franchising already has pushed company units to 66% of total Shoney's units from 76% of the chain in 1987.

PROTECTING BOTTOM LINES

For many chains, a growing inability to achieve consistent sales and profit gains is driving the shift toward franchising, according to industry executives and analysts. "The problem with company-owned operations, which Carl's and McDonald's and Wendy's have experienced, is that they're a lot more volatile than franchise systems. When business isn't as good, the risk to profitability is much greater when it's a company-owned restaurant vs. a franchised restaurant," says analyst Michael Mueller of Montgomery Securities, San Francisco.

Because revenues from franchised restaurants come from fees paid as a percent of sales, often with specified minimum payments, income from franchising rises with increased sales, but is insulated from spikes in operating costs, such as food and labor. Franchisors even stand to benefit from the value pricing and discounting tactics—which tend to boost sales, but can play havoc with unit margins—that are rampant in the industry.

"Franchising stabilizes your bottom line, and your predictability is much greater because you have a constant income stream. When [a chain is] totally company owned, you share in the great times, but it's real tough in the hard times," says Rory Murphy, vice president of franchising for Carl's Jr.

Oak Brook, Ill.-based McDonald's is among the companies struggling with U.S. stores. With almost 8,800 domestic units, McDonald's has difficulty adding new stores without cannibalizing sales at existing restaurants. In addition, a shortage of prime sites has driven up building costs. After accounting for menu-price inflation, average sales at McDonald's U.S. company stores have declined in four of the past five years.

Meanwhile, the costs of opening a new McDonald's—including land, building and equipment—have increased 28% over the same period, to about $1.6 million. By the beginning of 1991, nontraditional sites—in malls, in hospitals, on toll roads and the like—accounted for fully 30% of McDonald's U.S. locations, the company says.

McDonald's has moved to limit its exposure by placing underperforming stores in the hands of franchisees. "Some of the restaurants, they just can't operate that well. The franchisees can operate them more efficiently," says Mueller.

Steven Rockwell, a restaurant analyst for Alex. Brown, Baltimore, agrees: "The company has indicated that it has wanted to increase the percentage of franchised units because the franchisees, the owner-operators, will typically do a better job of running those units."

McDonald's spokesman Chuck Ebeling denies that the steady drop in company stores reflects a specific strategy. "We buy and sell restaurants on an on-going basis," he says. "That's sort of just the way the numbers have come out." But he acknowledges McDonald's interest in placing units in the hands of franchisees. "We've always made the point that there's nothing like having an entrepreneur or franchisee operating a business, because their commitment to a McDonald's restaurant is so tremendous."

CUTTING INVESTMENT COSTS

The low cost of franchising relative to opening company stores is the second major factor contributing to the increase in franchising. Franchisees'

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FRANCHISING

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investment in new restaurants enables parent companies to raise earnings without spending or risking their own cash. And growth companies can expand much faster through franchising than on their own, because they use the resources of their partners.

In 1988, citing the growing saturation of the restaurant market, Nashville, Tenn.-based Shoney's undertook a $728 million recapitalization, which included $585 million in bank borrowings. Although the restructuring has allowed for modest company-store expansion, Shoney's debt service limits its ability to invest in new stores. Franchising lets the company broaden its operating base without diverting cash flows from its debt pay-downs.

Franchising also provides new customers for Shoney's manufacturing and commissary businesses, which—buoyed by sales to new franchisees—are growing faster than any of its other divisions. Last year, pretax income from those operations grew 46% and sales gained 26%, according to company reports.

Steak 'N Shake, Indianapolis, also recapitalized last year and concurrently announced its intention to step up franchising. The company, which ended 1990 with only 11% of its 117 restaurants franchised, says its long-term goal is to increase franchised units to 33% of its system.

Perkins' reliance on franchising for growth is largely a function of its structure as a limited partnership. The Memphis, Tenn.-based chain regularly pays out to unit holders dividends that represent more than 90% of its net profits. The heavy dividends keep the company's working capital negative, which makes less costly investments such as franchising more appealing.

> **"When a chain is totally company owned, you share in the great times, but it's real tough in the hard times."**
> **—Rory Murphy, Carl's Jr.**

At McDonald's, as at other franchised operations, franchisees provide capital by purchasing equipment, signs, seating and decor packages, and, over the long term, remodeling and reinvesting in their businesses. They also share in investments in the sites and restaurants through franchise and lease agreements. But unlike most franchisors, McDonald's owns or controls most sites and stores in its system—franchised as well as company-operated.

The money McDonald's saves by franchising at home, where the fast-food market is mature, often finds its way overseas, where the company now derives most of its sales and profit gains. "The company is attempting to redeploy its assets out of the U.S., selling off or franchising its units domestically, taking whatever capital they get out of that and redeploying it internationally, where they're getting a higher return," says Rockwell.

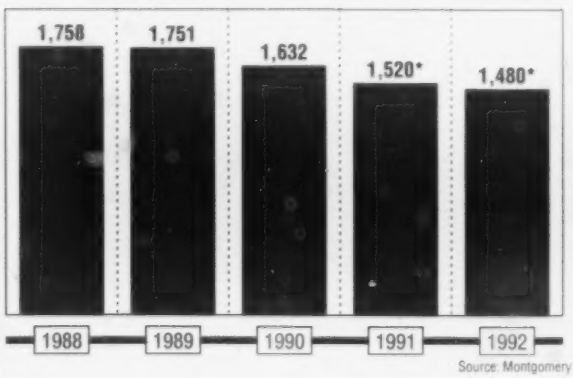
In 1990, foreign units represented 27% of the McDonald's system, but provided 42% of the company's revenues and 51% of company-operated restaurant margins, according to company reports.

Dublin, Ohio-based Wendy's also has employed a strategy of selling or franchising company stores. Wendy's, however, uses the money to rejuvenate its U.S. system. It buys distressed franchises, which it refurbishes and refranchises. "It's an effort to clean up the system," says Mueller. "They couldn't rely on the franchisees to do it, so they kind of had to do it themselves."

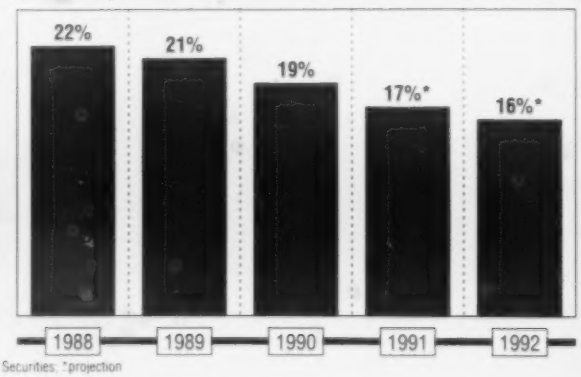
Five years ago, Wendy's had more than 800 troubled restaurants—the result of rapid growth—but today it has closed or revitalized all but about 150 of the weak units, according to analyst William Barr of Value Line Investment Survey, New York. Aided by a recent debt offering, Wendy's is poised to accelerate expansion of both company-owned and franchised restaurants. Its plans call for opening franchises at about twice the rate of company stores.

At Carl's Jr., whose core Southern California market is among the most brutally competitive in the nation, management has rethought its strategy of branching out through company-owned units. The Anaheim, Calif.-based burger chain is franchising its company stores in the San Francisco area as well as in Colorado and creating development agreements and incentives to encourage franchisees to fill their markets quickly. *continued on page 83*

MCDONALD'S PARES U.S. COMPANY UNITS



MCDONALD'S COMPANY STORES DROP AS PERCENTAGE OF U.S. SYSTEM



Source: Montgomery Securities; *projection

FRANCHISING

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Executives say franchising secondary markets will provide downside protection for besieged margins while freeing up the cash the company needs to grow in its core markets. By clustering stores in each of its markets, Carl's hopes to gain the efficiency to counter TV assaults by such giants as McDonald's and Burger King.

Like McDonald's, Carl's Jr. says it depends on its franchisees for more than their capital: For example, franchisee companies can help meet challenges, such as finding sites. Murphy offers the newly franchised San Francisco market as an example: Rather than having two corporate real estate managers working on up to 50 sites at a time, he says, as many as 17 franchisees now will be involved in locating new stores. The result, he says, will be higher-quality sites and faster development. "When you have 17 individuals working on sites, it happens much quicker, and the prime sites are usually available because the franchisee will spend a lot of extra time on that certain site that they want."

SACRIFICING CONTROL?

For all its benefits, franchising can have a downside, even for chains with sophisticated franchisee training and support systems. Companies that franchise simply have less control over their systems than those that don't, which can affect consistency and speed of reaction.

Before they can sell their programs, franchise companies often must overcome franchisees' innate suspicion that parent companies are interested in raising sales, thereby increasing their fee income, without regard to franchisee profitability.

> "I think some companies have forgotten to say thank you to their franchisees and recognize them as investors."
> —Russ Cooper, Shoney's

Russ Cooper, Shoney's senior vice president of franchising and development, contends such problems are failures of philosophy, not franchising. "I think some companies have forgotten to say please and thank you to their franchisees and recognize them as investors. And that's been cause for problems in some systems."

Involving franchisees in the decision-making process helps avoid many complications, says Cooper. "You have to be willing to accept that franchisees are your partners, and you have to be willing to listen to your partners. If you're not, then you shouldn't be franchising." Franchisees sit on Shoney's franchise, marketing, and buildings and equipment advisory boards.

But even Shoney's has had to prove ideas to franchisees before they all accepted them. For example, some franchisees balked early on at the company's idea of accepting payment by credit card. Other top franchisors have faced similar challenges. Recently, for example, International Dairy Queen has had problems convincing many of its franchisees to take on debt for remodels, even though the revamped units generate higher sales.

Still, Cooper says he believes the give and take between franchisor and franchisee results in a stronger system: "We value franchisee input. I think they're really the people who are closest to the customers and the market."

COMPANY SYSTEMS

Analysts point to the General Mills restaurant concepts—Red Lobster and The Olive Garden—as examples of the tremendous efficiencies possible from company operations. The two chains are among the top performers in the industry, and they credit company ownership for much of their success.

"In today's operating environment, consumers are changing their wishes and their demands and their preferences faster than they ever have in the history of our industry, and in franchise operations a lot of times, you have to first sell your franchisees if the program involves a capital expenditure," says Anne Powell, a spokeswoman for General Mills Restaurants, Orlando, Fla. "We don't have to do that."

Red Lobster has rolled out a computer system that reportedly saves the company more than $10 million annually in labor costs through more efficient scheduling. "If we had franchisees, we first would have had to convince them to make the investment in that equipment," Powell contends.

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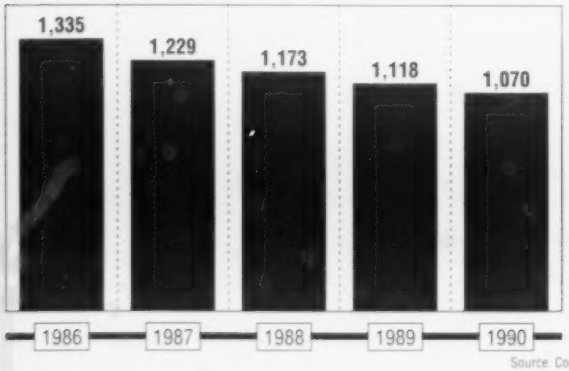
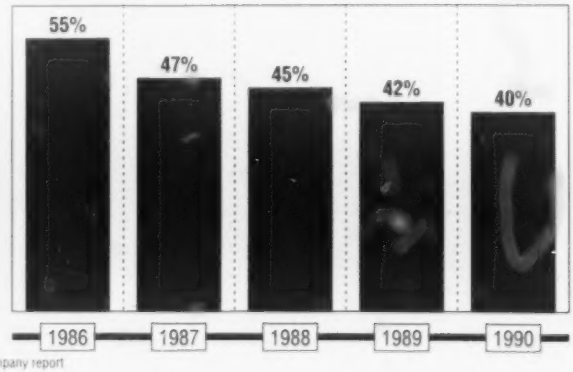
WENDY'S SELLS COMPANY STORES



WENDY'S-OWNED STORES FALL AS A PERCENTAGE OF U.S. SYSTEM



Source: Company report

FRANCHISING

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Similarly, PepsiCo's restaurant concepts—Pizza Hut, KFC and Taco Bell—each of which leads its segment in sales, are growing their domestic systems by adding company stores. In 1990, PepsiCo, Purchase, N.Y., increased company-owned stores about 8% in the United States, while franchisees netted only 1% unit growth for the year. From 1986 to 1990, the number of U.S. company stores grew 36%, while franchised units grew by 14%. Already this year, the company has added more than 200 KFC franchises to its list of buy-backs.

Why is PepsiCo buying up franchises? "Control is one reason, for sure, because you can provide better service and better food quality, generally, and you can implement changes faster, which is getting to be more important," says Mueller.

> "You have to first sell your franchisees if the program involves a capital expenditure."
> —Anne Powell, General Mills Restaurants

Another reason is that restaurant companies can make as much as five times more money with a well-run company-owned restaurant than they can with a franchised restaurant. "If you collect a royalty fee, it might be 4% or 5% of sales. If the company's well-run, the pretax contribution from an owned restaurant might be more like 20%," says Mueller. Because PepsiCo's large base makes high-percentage growth difficult, the best way for it to increase earnings is to buy back stores.

And PepsiCo's own history of control problems and disputes with franchisees also makes buying dissident franchisees attractive. Says one executive: "One way to take care of the problem is to remove it." R&I

TOP 20 FRANCHISEES

Company	1990 sales	1990 units	Key concepts
1. Spartan Food Systems	$510.5MM	483	Hardee's
2. Boddie-Noell Ent.	298.0	287	Hardee's
3. TPI Restaurants	239.4	232	Shoney's, Captain D's
4. National Pizza Co.	198.0	366	Pizza Hut
5. Harman Mgmt. Co.	190.0	243	KFC
6. National Restaurant Mgmt.	185.0*	185*	Diversified
7. RTM	169.5	264	Arby's
8. RPM Pizza	153.9	355	Domino's
9. Pizza Mgmt.	150.0	234	Pizza Hut
10. Carrols	149.5	163	Burger King
11. Collins Foods Intl.	140.0	209	KFC
12. Restaurant Mgmt. Services	104.0	118	Shoney's, Captain D's
13. Sybra	103.6	154	Arby's
14. Consul Restaurants	88.3	51	Chi-Chi's
15. Restaurant Mgmt.	72.1	129	Pizza Hut, Long John Silver's, Grandy's
16. Forbco Mgmt.	68.5	38	Sizzler
17. U.S. Restaurants	68.1	65	Ponderosa, Burger King
18. Buehler-Ruckriegel	67.1	115	Long John Silver's
19. Atlanta Family Restaurants	65.0	46	Shoney's
20. Marcus Restaurants	60.0	74	KFC, Big Boy

Information based on available data. *R&I estimate.

TOP 20 FRANCHISORS

Company	Domestic franchised units	Foreign franchised units
1. McDonald's	6,944	2,216
2. Kentucky Fried Chicken	3,617	2,763
3. Subway	5,111	243
4. Dairy Queen	4,617	587
5. Burger King	4,471	641
6. Pizza Hut	3,200	1,400
7. Domino's Pizza	3,835	373
8. Baskin-Robbins Ice Cream	2,143	1,040
9. Hardee's	2,628	42
10. Wendy's	2,454	203
11. Arby's	2,051	115
12. TCBY	1,604	73
13. Taco Bell	1,376	18
14. Sonic Industries	949	0
15. Big Boy	734	68
16. A&W Restaurants	668	72
17. Popeyes Chicken & Biscuits	649	8
18. Carvel Ice Cream Bakery	652	0
19. Orange Julius	466	148
20. Round Table Pizza	560	3

Based on domestic and foreign unit counts from *R&I* 400 data.

ACTION EXPRESS

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RESTAURANTS & INSTITUTIONS, a Cahners publication
1350 E. Touhy Ave., P.O. Box 5080, Des Plaines, IL 60017-5080 Phone: 708/635-8800

Cahners Publishing Company, A Division of Reed Publishing USA ☐ Specialized Business Magazines for Building & Construction ☐ Research ☐ Technology ☐ Electronics ☐ Computing ☐ Printing ☐ Publishing ☐ Health Care ☐ Foodservice ☐ Packaging ☐ Environmental Engineering ☐ Manufacturing ☐ Entertainment ☐ Media ☐ Home Furnishings ☐ Interior Design ☐ and Lodging. Specialized Consumer Magazines for Child Care ☐ Boating ☐ and Wedding Planning.

RESTAURANTS & INSTITUTIONS (ISSN 0273-5520) (GST #123397457) is published biweekly (with an additional issue in January, May, August, September and November, and two extra issues in March) in national, demographic and separate editions by the Cahners Publishing Company (subscription includes all issues). Cahners Publishing Company is a Division of Reed Publishing USA, 275 Washington St., Newton, MA 02158-1630. Terrence M. McDermott, President; Frank J. Sibley, Executive Vice President; Charles H. Moodhe, Senior Vice President/General Manager, Chicago Division; Jerry D. Neth, Senior Vice President/Publishing Operations; J.J. Walsh, Senior Vice President/Finance; Thomas J. Dellamaria, Senior Vice President/Production and Manufacturing; Ralph Knupp, Vice President/Human Resources. Circulation records are maintained at Cahners Publishing Company, 44 Cook St., Denver, CO 80206-5800. Phone: 303/388-4511. Second-class postage paid at Denver, CO 80206-5800 and additional mailing offices. **Postmaster: Send address corrections to RESTAURANTS & INSTITUTIONS, P.O. Box 173377, Denver, CO 80217-3377.** RESTAURANTS & INSTITUTIONS copyright 1991 by Reed Publishing USA. Ronald G. Segel, Chairman and Chief Executive Officer; Robert L. Krakoff, President and Chief Operating Officer; William M. Platt, Sr. Vice President. Annual subscription rates for nonqualified people: USA, 1 year $104.95, 2 years $204.95; Canada, 1 year $192.55, 2 years $326.30; Mexico, 1 year $179.95, 2 years $304.95; other countries, 1 year $234.95, 2 years $399.95 for surface mail and 1 year $374.95, 2 years $679.95 for air mail. Single copies are available for $15 (USA, Canada, Mexico and foreign). The March 27, July 10, July 24 issues are available for $25 (USA, Canada Mexico and foreign). Please address all subscription mail to RESTAURANTS & INSTITUTIONS, 44 Cook St., Denver, CO 80206-5800. RESTAURANTS & INSTITUTIONS has also been published as "INSTITUTIONS, Magazine of the Service World" and INSTITUTIONS/VOLUME FEEDING MANAGEMENT. RESTAURANTS & INSTITUTIONS and R&I are registered trademarks of Reed Properties Inc., used under license.